Extend or Forbear?
A Servicer's Guide to Navigating a CMBS Loan Restructuring

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The continuing economic recession has greatly exacerbated the default of borrowers under CMBS loans. The overall delinquency rate for CMBS loans rose for a fourth consecutive month in June of 2012 to 10.16 percent.[1] Commercial property cash flow deficits and lower property values have made it more difficult for borrowers to refinance and have prevented lenders from recovering all of their losses in a foreclosure. More than ever, lenders and servicers are now interested in restructuring defaulted CMBS loans in the hope that in the not-so-distant future, these properties will generate increased cash flow and substantially increase in value.

The tough decisions, when it comes to a restructuring of debt, most often lie with the special servicer. Upon a maturity default, a loan's pooling and servicing agreement requires that a special servicer take over the servicing of the defaulted loan and take some corrective action which, pursuant to accepted servicing practices, should result in the best of all possible outcomes for the certificateholders. Between 2007 and 2011, approximately $82 billion in CMBS loans were resolved in one way or another.[2] Yet, in a volatile real estate market, the special servicer may find that delaying the commencement of a foreclosure or accepting a deed in lieu may actually improve the certificateholders' position. On average, a foreclosure results in higher losses for the certificateholders because during the entire time the loan is going through the foreclosure and through the eventual sale of the collateral, certificateholders are generally required to have payments of interest kept current This results in the trust making advances and interest being charged to fund those advances to the certificateholders, which may result in loss given the super-priority position of the reimbursement of advances (and interest on such advances).[3] If the special servicer decides that a restructuring of the indebtedness instead of a foreclosure, deed in lieu, note sale or other disposition would be preferable for all certificateholders, the special servicer must then choose whether to extend the maturity date or forbear from exercising remedies. While an extension will always be a borrower's preference, a formidable forbearance often gives lenders and servicers added protection. The competing

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[1] *See* Al Yoon, "CMBS Delinquencies Rise, But Refinancings Are 'Sweet,'" *Wall Street Journal*, July 3, 2012.

[2] *See Id*.

[3] *See* Ann Hambly, "Where, Oh Where Have All the CMBS Defaults Gone?" ReBusiness Online, January 4, 2012, http://www.rebusinessonline.com/main.cfm?id=21598.

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needs of the capital stack make this choice that much more difficult. Generally, the classes purchased at a premium desire to recoup their investment as early as possible, while the classes purchased at a discount wish for the transaction to continue. This tension is inherent in any senior/subordinate structure and plays itself out in the context of choosing extension over forbearance.

The Making of an Effective Extension Agreement

Black's Law Dictionary defines extension as, *inter alia*, "[a] creditor's indulgence by giving a debtor further time to pay an existing debt," and forbearance as the act of "refraining from action." While foreclosure is always an option upon a maturity default, borrowers almost always prefer an extension of the maturity date. An extension forgives a maturity default and provides a borrower additional time to pay the existing debt, subject to the terms and conditions of the extension. The terms of the extension agreement could provide for any number of modifications to the loan documents, including a possible principal paydown, the implementation of cash management, full cash sweeps, additional reserves and reaffirmations of representations and warranties. However, unlike a forbearance, the actual maturity date is extended and the default, which is the basis of such extension, no longer exists. It is as if the default never occurred in the first place. The loan is in good standing with the lender with no default, and it should be transferred back to the master servicer after a period of time set forth in the related pooling and servicing agreement. One of the principal benefits of the extension to the borrower is that such borrower is not publicly tarnished with a reputation as being a "defaulted borrower." Such a borrower may continue to seek capital from potential investors, future lenders and its own affiliates without worrying that any existing defaults will be viewed as a severe credit risk or impairment.

In the context of loans subject to intercreditor arrangements, participations and synthetically created loan-specific securities (i.e., "rake bonds"), subordinate debtholders should also prefer extensions. If a borrower is no longer in default, subordinate debtholders will usually continue to be paid monthly debt service under the related pre-event of default waterfall and the positions senior to it in the capital stack will not be subject to recharacterization of principal (i.e., "turbo-payments"). Accordingly, an extension may offer greater flexibility and a better strategy for rehabilitating a troubled loan than a foreclosure. While the allure of "immediate recovery" in a foreclosure is intriguing, it may just be an illusion. Things are never immediate, and there are hidden and very real costs associated with the sale and disposition of an asset, particularly in a market that is still not completely stabilized. An extension however, may not always be the best strategy for rehabilitating a troubled loan and a well-crafted forbearance may provide a proverbial "Sword of Damocles" over the head of an unreasonable borrower.

Drafting a Formidable Forbearance

As noted above, forbearance means the act of "refraining from action." Under a forbearance, the lender and special servicer do not forgive any maturity default or other default. Instead, the lender forbears for a time from taking any enforcement action available to it under the loan documents. Forbearance preserves the lender's remedies because the original default is never cured. While the lender has agreed to delay or suspend the enforcement of its rights, such rights continue to exist. A well-drafted forbearance agreement will maximize the benefit to the senior certificateholders. Like an extension, the lender has the ability to request modifications to the loan documents as a condition to the forbearance. These modifications can strengthen the position of the lender through cash sweeps and prepayments of principal, but also afford

all parties an opportunity to craft changes that simultaneously strengthen the value of the borrower's property and make it more attractive to other lenders and takeout financing. Lenders (or a servicer or special servicer on its behalf) may and usually should also include language in any forbearance requiring the borrower (and any guarantor) to consent to jurisdiction if any lawsuit or foreclosure is later commenced. As discussed later in further detail, in most forbearances, the borrower typically agrees to waive its right to the automatic stay if it later defaults under the forbearance agreement and declares bankruptcy (although that waiver may not be enforced by the bankruptcy court under its equitable powers). In addition to lender-friendly modifications, the special servicer can also negotiate specific conditions to the continuance of the forbearance period, which would enable the special servicer to closely monitor the borrower and property's performance. For example, the special servicer may negotiate specific financial or property-level tests and covenants (such as debt service coverage ratios, occupancy tests or franchise default triggers); and the failure to satisfy such conditions will terminate the forbearance period.

Forbearance also gives the lender and special servicer the opportunity to identify all existing defaults. Many times in a restructuring, there are numerous, non-monetary events of default that need to be addressed and resolved. If the loan is merely extended, such defaults are not necessarily addressed or acknowledged. In a forbearance, however, the borrower must acknowledge all existing defaults and certify to the lender that no other defaults are then outstanding. If the lender later discovers any undisclosed defaults under the loan and proceeds to exercise its available rights and remedies, such acknowledgment under the forbearance agreement will preclude the borrower from claiming waiver or laches[4] as an affirmative defense. Accordingly, during the continuance of the forbearance, because the default continues uncured, funds from the property should be applied pursuant to the post-event of default waterfall, preventing any payments of debt service to subordinate debtholders. The loan will remain subject to special servicing, the event of default will remain in continuance, and accordingly, the loan should not return to "performing status," nor be subject to servicing by the master servicer.

The IRS Code further recognizes the distinctiveness of the forbearance agreement, particularly if the forbearance period is less than two years. The Treasury Regulations provide, in part, that "an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds (A) two years following the issuer's initial failure to perform; and (B) any additional period during which the parties conduct good faith negotiations or during which the issuer is in a title 11 or similar case."[5] However, the Treasury Regulations are only a guide and do not conclusively hold that all forbearances must be for no longer than two years. Neither statutory nor judicial precedent provides any guidance as to what the length of a forbearance should be; thus, a longer forbearance period may be permissible under a given set of circumstances. But, any longer forbearance may increase risk and should be entered into only on a case-by-case basis.

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[4] Laches is a legal doctrine, which states that a legal right or claim will not be enforced if the party asserting such legal right or claim has unnecessarily delayed making such claim and such delay has prejudiced the defending party.

[5] *See* 26 C.F.R. § 1.1001-3(c)(4)(ii) (2011).

In other words, the special servicer must carefully analyze the particular asset and the exigent circumstances surrounding such asset including, but not limited to:

- jurisdiction,
- the borrower's capability to rehabilitate the property,
- the financial health of the geographic market where the property resides,
- the cost and delay of foreclosure,
- the interest rate and movement, and
- the appraisal value of the property.

Stated differently, the special servicers must make decisions consistent with the "servicing standard" to which they are subject considering the totality of the facts and circumstances of the particular workout. In essence, a well-crafted forbearance does have certain advantages over an extension by keeping the event of the default that triggered the forbearance in place, as well as cleaning up any legal inconsistences or discrepancies that may exist in the underlying legal documentation. The forbearance gives lenders (and servicers or special servicers, on their behalf) an added ability to act quickly and decisively in enforcing their rights if the loan becomes again (or further) distressed during the forbearance period.

Benefits of a Forbearance in Bankruptcy

Many forbearance agreements require a borrower to waive its right to declare bankruptcy, although such provisions are not likely enforceable by reason of public policy. Courts have begun to recognize the inevitable "tension between affording a debtor the protection to which it is entitled under the Bankruptcy Code, and furthering the legitimate public policy of encouraging out-of-court restructurings and settlements."[6] As a result, courts have enforced waivers of bankruptcy's automatic stay, from time-to-time, to permit lenders to foreclose on their collateral. In determining whether to enforce a waiver of the automatic stay, bankruptcy courts consider factors such as: (i) the sophistication of the party making the waiver, (ii) the consideration for the waiver, including the risk and length of time of the lender's forbearance, (iii) the potential effects on other creditors and (iv) the feasibility of the debtor's plan.[7] Thus, forbearance agreements can offer lenders added protection in the event that a borrower, after such forbearance period, pursues bankruptcy, the lender will likely not be hindered in their efforts to subsequently foreclose.

Balancing the Interests of Certificateholders and Subordinate Debtholders

Yet, whether an extension or forbearance is the optimal outcome can be a nuanced, case-specific question depending on the overall structure of the financing and the present value of the property. Special servicers must clearly offer their rationale for an extension or forbearance and prove to their certificateholders

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[6] *See* Katherine A. Burroughs and H. Jeffrey Schwarz, "Forbearance Agreement," *New York Law Journal – Corporate Restructuring and Bankruptcy* (Sept. 2008).

[7] *In re Bryan Rd., LLC*, No. 07-17922, slip, op. (S.D. Fla. 2008); *In re Desai*, 282 B.R. 527 (S.D. Ga. 2002) (finding that a pre-petition workout agreement where the debtor consented, on the eve of a foreclosure sale, to waive its right to the automatic stay was enforceable).

that such action will benefit those certificateholders in the aggregate, more so than any other corrective mechanism, including foreclosure, deed-in-lieu, or note sale.

In addition to special servicers' duty to their certificateholders to act in their best interest, special servicers in highly structured deals generally must also seek the consent or approval of the subordinate debtholders. Thus, the special servicer must delicately balance competing interests. If subordinate debt exists with respect to the property, most extensions permit cash flow from the property to be allocated to those subordinate debtholders, depriving the senior certificateholders of those additional cash receipts. In order to protect the senior certificateholders, effective extension agreements will include lender-favorable loan modifications including, among other things, the implementation of hard cash management and cash flow sweeps, additional reserves for needed upgrades to the property and substantial prepayments of principal, in addition to a reaffirmation of representations, warranties and covenants made by the borrower and guarantor at the origination of the loan.

But even with these lender-friendly modifications, the special servicer may find it difficult to convince its certificateholders that such an extension is in their best interest. If conditions change and the property value declines further, an extension deprives the servicer of its ability to exercise any remedies or take any enforcement action until a new event of default occurs. Yet, a forbearance agreement is not always a popular alternative. While subordinate debtholders will object to a forbearance, because such an agreement deprives them of any future cash flow, senior certificateholders may also object to a forbearance, claiming that it is nothing more than a technical distinction from an extension, delaying immediate payment to certificateholders.

However, depending on the exigencies of the situation, choosing an extension over a forbearance or vice versa, and, in any event, choosing these resolutions over enforcement or disposition may make the most sense. Such a decision is predicated upon, *inter alia*, an analysis and prediction of the potential value of the property, access to capital, quality of management, geographic location, and interest rates and the other factors discussed earlier herein.

Correcting a Misconception: The Forbearance Is Not an Extension

There are some lenders and servicers who maintain that the forbearance and the extension are a difference in terminology only. They believe that they may be different in form but essentially the same in substance. As discussed above, a forbearance is as much an extension as a securitization is the same as a sale of whole loans. While the sale and the securitization are both tools of loan disposition, they are markedly different in form, substance, impact and effect. In comparison, an extension and a forbearance are both available tools for dealing with troubled assets, but they are different in form, substance, impact and effect. The extension, as noted above, treats the event of default as if it never occurred, while the forbearance leaves the event of default in place. In many syndicated contexts, since the extension returns a loan to "performing status," the holders in the loan will be entitled to the "current pay" of interest and the "pro rata" disposition of principal. With a well-crafted forbearance since the event of default remains in place, in most instances, the senior portions are subject to "hyper-amortization" of their interests while the junior portions accrue, but do not receive payment, until the senior portion is retired in full. The extension may also make it difficult to take action in the event that a loan again becomes subject

to distress while a forbearance may facilitate the speed of response given the event of default remains in place. In addition as noted, the forbearance may have some advantages with respect to insolvency matters that the extension may not have. Borrowers consent to or waive valuable contractual rights in a forbearance agreement that would otherwise be available to them, thus very often saving servicers and certificateholders critical time and money. Accordingly, to classify a forbearance as an extension is not to understand completely the power of the forbearance and/or the situations in which either resolution tool might be the better strategy.

Making the Best Choice and Following Accepted Servicing Practices

Before the special servicer can choose to forbear, however, as discussed above, it must consult with and often seek consent of the controlling, subordinate debtholder(s). Not only do the pooling and servicing agreement, intercreditor and participation and servicing agreements require this consultation and consent, if the controlling, subordinate debtholders disagree with the course of action taken by a special servicer, they have the power to replace a special servicer. Special servicers must take special care to negotiate a solution that keeps the best interest of their certificateholders in mind, while also obtaining consent of the related controlling class, all the while servicing in accordance with the related contractually obligated standard of care (i.e., "accepted servicing practices").[8] A misstep can result in either replacement of the special servicer or litigation—subjecting the special servicer to liability.

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[8] Though most pooling and servicing agreements, intercreditor agreements and participation agreements require the special servicer to consult with the controlling class and obtain such class' consent before taking any action after a maturity default, if such controlling class refuses to give their necessary consent, the special servicer is still obligated to take such action required in order to fulfill its obligations to certificateholders in accordance with accepted servicing practices.

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